Kenneth A. Simpler
State Treasurer

TEL: 302.672.6700
FAX: 302.739.2274

MINUTES FROM MEETING OF THE INVESTMENT SUBCOMMITTEE OF THE CASH MANAGEMENT POLICY BOARD
July 27, 2016

A Telephonic Meeting of the Investment Subcommittee of the Cash Management Policy Board was Held on Wednesday, July 27, 2016 at 2:00 PM in the Conference Room of the Office of the State Treasurer Located at 820 Silver Lake Blvd., Suite 100, Dover, Delaware.

Board Members in Attendance:
Mr. David Marvin, Chair, Investment Subcommittee of the Cash Management Policy Board (Telephonically)
Mr. Mike Karia, Co-Chair, Investment Subcommittee of the Cash Management Policy Board (Telephonically)
The Honorable Ken Simpler, State Treasurer (Telephonically)
Mr. John Flynn, Chairman, Cash Management Policy Board (Telephonically)

Board Members Not in Attendance:
The Honorable Tom Cook, Secretary, Department of Finance

Others in Attendance:
Ms. Laura Gerard, Deputy Attorney General, OST Counsel (Telephonically)
Mr. John Krimmel, NEPC (Telephonically)
Mr. Steve McVay, Director of Investments and Cash Management, Office of the State Treasurer
Ms. Susan Steward, Policy Advisor, Office of the State Treasurer
Ms. Martha Sturtevant, Executive Assistant to the State Treasurer
Ms. Erin Niehorster, Administrative Specialist, Office of the State Treasurer

CALLED TO ORDER
Mr. Simpler called the meeting to order at 2:03 PM.

APPROVAL OF MINUTES FROM MAY 2, 2016, MEETING
Mr. Simpler asked the subcommittee members for any comments regarding the previous subcommittee meeting minutes and none were offered. Mr. Karia moved to approve the minutes and the MOTION was seconded by Mr. Marvin. MOTION UNAMIOUSLY APPROVED.

OPERATING ACCOUNTS MEMO
Mr. Simpler previewed the new guidelines for operating accounts and the current investment practices of these accounts by OST. These are accounts that are held by the state but are classified neither as liquidity nor reserve funds. The attached table outlines the details of the different types of these accounts that are currently held by the State or organizations within the State. Mr. Simpler referred to the statute that established the CMPB that he feels ambiguously gives the board responsibility for setting policies for the investment of all state monies except pensions and deferred compensation. Mr. Simpler reviewed the operating accounts with the Investment

Subcommittee to obtain either their approval for the way the account is being currently managed or initiate a discussion about changes the Subcommittee believes are necessary for any particular account.

The Health Fund Account is a special fund receiving annual payments under the Master Settlement between the State and Tobacco Manufacturers. This account was set up in 2005. Monies deposited to the account are appropriated within a fiscal year. Currently, this fund is held in the "reserve" category though the funds are more liquid in nature. Mr. Simpler believed this account more accurately reflects the definition of an "operating account" and moves that the Subcommittee change the category of this account from a reserve to a liquidity account.

Mr. Marvin agreed that these monies seem to be more in line with the State's liquidity accounts and seconds Mr. Simpler's MOTION for the account's re-classification. With no opposition, MOTION UNAMIOUSLY APPROVED.

The Budget Reserve Account, or 'Rainy Day Fund', was established in 1977 and is also classified as a reserve account. All monies in the account are held by one investment manager, JPMorgan. Mr. Simpler asked whether or not it is a sound practice to have all funds with one manager rather than allocated between the five investment managers used by the State. Currently, there is a 1.2% cushion in the account, approximately $2 million, that the State keeps in the account at all times in case of fluctuations in market value. Mr. Simpler discussed the idea that the amount of the cushion should be evaluated. The funds in the Rainy Day account have never been drawn upon.

Mr. Karia referred to a previous discussion by the full Board that frowned upon the idea of having multiple "pots" of small amounts of money allocated across different managers. The preference of the Board, at that time, was to keep the fund with one custodian.

Mr. Marvin offered an explanation as the history behind the Board's decision to use one manager. The Board looked at two banks (in the early 1980s) to provide investment management services. These two banks were Citi Group and JPMorgan. The Board felt that, historically, JPMorgan placed a greater emphasis on safety in their operations and was chosen.

Mr. Flynn feels that if it is maintained separately, we should ask JPMorgan to provide a stress-test to the State in its reporting to show the effect on the monies should interest rates rise or credit spreads increase. Mr. Flynn believes this additional level of reporting would comfort the board in how the funds would be affected in a three standard deviation event. Mr. Marvin elaborated that using JPMorgan shows the people of Delaware that the State is using strong judgment and smart choices to protect the principal investments of the State.

Mr. Simpler agreed with the information provided by Mr. Flynn and Mr. Marvin and stated that their insight strengthens the case to classify the Rainy Day Fund as an Operating Account rather than a Reserve Account. Mr. Marvin believes that the importance here is not with the specific mandate of the account but rather the deterioration of global financial conditions. He states that JP Morgan can adapt to these global changes in a way that increases the protection of the funds under their purview. Mr. Simpler agreed with the assessments of the Subcommittee and suggested working with NEPC to develop a recommendation on changing the current level of cushion in this account.

The Land and Water Endowment Cash Account is where required cash for the Land and Water Endowment are kept. Mr. Simpler stated that Board approved the policy of keeping a cash account in regards to an issue with using mutual funds. This cash account is targeted at a balance of 5.00% of the L&W money (currently this amount is approximately $3 million). This allowed the fund managers to invest fully. Mr. Simpler asked the Board about the decision to choose Blackrock Money Market Funds as the investment vehicle for these funds.

Mr. McVay stated that Blackrock is the default cash sweep fund used by the custodian for investment manager accounts held by the state. The choice of investment has not been reviewed or changed for as long as Mr. McVay has been with the State of Delaware.

Mr. Flynn stated that if the investment custodian changes as a result of the negotiations with Northern Trust, this may allow for the board to reconsider investing these monies with Blackrock.

Mr. Marvin echoed Mr. Flynn in that the change of custodian will allow for the Subcommittee to reevaluate the investment of these funds.

The Bond Proceeds account is used for debt proceeds that are earmarked to fund specific capital projects. The projects aren't always funded immediately but normally within twelve months. The monies held in this account are invested at the discretion of the CMPB. Mr. Simpler asked whether or not it would be prudent to treat these monies as liquidity funds or keep them in a separate government money market fund. There is no mandate that requires these funds to be kept in a separate account from other State monies.

Mr. Karia inquired if the bond covenant lists any guidelines that specify where unspent bond proceeds are kept. He suggested that OST research to ensure their compliance with the bond covenant. Ms. Steward pointed out that in Title 29, Chapter 74 of the Delaware Code that it states in subsection 74-14 that "all proceeds from sales of bonds or notes other than the premium or accrued interest shall be deposited by the state Treasurer in a special fund(s) of the State and applied for which such bonds or notes were issued or otherwise provided by law." The choice of account for bond proceeds (Fidelity) would have come from the OST.

Mr. Simpler stated that the "Bond Escrow Accounts" have no Board discretion but were included in the table to ensure the Board is aware these funds.

"Outside Bank Accounts" are held by state agencies and school districts for petty cash and other non-petty cash purposes. OST and the Division of Accounting have identified specific banks for these accounts to be held; PNC Bank, WSFS, Citizens, and M&T. Mr. Simpler identified approximately $44.5 million held in 309 accounts.

Mr. Marvin expressed his discomfort with the Board being responsible for the monies held in these accounts. He is concerned that there are relationships that exist between banks and holders that cannot be monitored.

Mr. Simpler elaborated that the statutes are about the Board's responsibility for setting policy rather than being a fiduciary for monies in outside bank accounts. The Division of Accounting (DOA) is the organization that allows these types of accounts. DOA and OST are responsible for ensuring accounts are opened with the right entities and used for approved purposes while being compliant with the Budget and Accounting Manual (BAM).

Mr. Karia requested that the guidelines be given to the members of the Banking Subcommittee and the full Board.

Finally, there are Outside Bank accounts that are held by some school districts and the Court of Chancery which are classified as investment accounts by the organization. Contact still needs to be made to the account holders to determine the purpose of these accounts to ensure BAM compliance as well as the Board-mandated requirements for investment accounts held by State Organizations.

Mr. Karia requested that the OST investigate these five accounts to ensure they are properly opened using the State EIN as well as properly collateralized to reduce the risk of loss.

INVESTMENT CUSTODIAN VENDOR RECOMMENDATION

Mr. McVay outlined the responses received for the Request for Proposal (RFP) that was posted in May 2016. There were four responses from the following banks: BNY Mellon (the incumbent), Wilmington Trust, Wells Fargo, and Northern Trust. Three of the four banks were chosen to give in-person presentations; BNY Mellon, Wells Fargo, and Northern Trust. Based upon the presentations as well as the initial proposal the evaluation team recommended selecting Northern Trust as best-suited to meet the state's needs. Northern Trust can meet the reporting needs of the State as well as having a user-friendly custody, accounting, and performance platforms. They also have a strong team to support public reporting of both Comprehensive Annual Financial Report (CAFR) and Governmental Accounting Standards Board (GASB). On behalf of the evaluation committee, Mr. McVay recommended that Northern Trust be selected to pursue contract negotiations to fulfill the role of Investment Custodian.

Mr. Flynn inquired whether or not there was a major price difference between the three banks. Mr. McVay stated that the initial offers were extremely close to one another.

Mr. Karia moved that the Investment Subcommittee recommends to the full CMPB to begin negotiations with Northern Trust. Mr. Marvin seconds the MOTION. Mr. Simpler asked for any oppositions; none were noted. MOTION UNAMIOUSLY APPROVED.

INVESTMENT GUIDELINES REVISIONS

Mr. Simpler reviewed the default rule that operating accounts will be maintained under the same guidelines as liquidity accounts unless the board determines otherwise and specifies the use a of designated financial institution.

STATUS OF LIQUIDITY ANALYSIS BY NEPC

Mr. Krimmel explained that the liquidity analysis is being broken down into four phases. The first phase is complete; historical cash flows have been collected for the liquidity and reserve funds. The preliminary conclusions of the cash forecasts is that the liquidity fund contains higher balances than necessary to meet liquidity needs and, as a result, the 50/50 split between funds could be shifted with more assets held in reserve funds.

Phase two will consist of stress tests to see how the funds would respond to rising interest rates if the allocation shifted from 50/50 to 60/40 or 70/30. NEPC forecasts that, in the future, there is a higher probability of an increase in interest rates rather than a decrease. Mr. Marvin interjected that a shift from 50/50 should take place in stages to negate the effect of market volatility and rising interest rates. NEPC recommendations using a dollar cost averaging approach to minimize risk.

Discussion ensued as to how investment managers interpret and follow benchmarks. Mr. Simpler hopes that the liquidity analysis will create a dialogue with managers that allows them to craft a plan based on their experience and understanding of the State benchmarks in conjunction with the current market.

NEW BUSINESS

There is no new business to present.

PUBLIC COMMENTS
There is no public present for comments.

ADJOURNMENT
A MOTION was made by Mr. Flynn and seconded by Mr. Karia to adjourn the meeting at 3:27 PM
MOTION ADOPTED UNANIMOUSLY

Respectfully submitted,

____
David Marvin
Chair for the Investment Subcommittee, Cash Management Policy Board

____
Mike Karia
Co-Chair for the Investment Subcommittee, Cash Management Policy Board